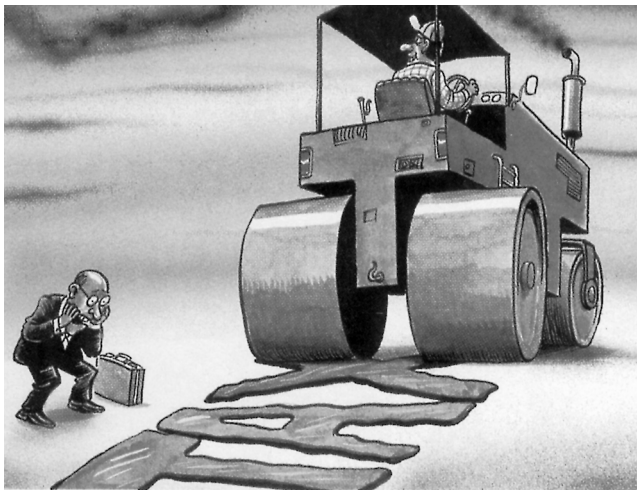


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## Charlemagne | Flat is beautiful



ONE of the more bizarre events on the Brussels calendar is the annual capitalist ball, staged by the Centre for the New Europe, a free-market think-tank with an appropriately Rumsfeld-like title. This year's event was dedicated to the memory of Ayn Rand, a libertarian novelist and one-time muse to America's Federal Reserve chairman, Alan Greenspan. Her dedication to capitalism was so complete that, at her memorial service, a six-foot high dollar sign was placed next to the open coffin. Previous balls featured a cigar-chomping American speaker in a tuxedo, pumping the air and encouraging shouts of "Viva capitalism".

The ball-goers are not what you might call mainstream Brussels. Officials from the European Commission are conspicuous by their absence. The core audience is drawn from a network of right-wing think-tanks in Europe and America. It would be easy to dismiss the whole thing as a fringe event. Who could be less relevant to the business of the European Union than a bunch of American conservatives and their wild-eyed fellow travellers from central Europe or Sweden?

But the free-marketters may now have the last laugh. One of their most cherished policy ideas—the flat tax—is fast gaining ground in Europe. To its proponents, the flat tax is the ultimate in fiscal simplification. If all corporate and personal income is taxed at a single flat rate, that slashes red tape and improves incentives. But flat-tax opponents have always countered that it is unjust not to have higher marginal rates for the rich. When Steve Forbes proposed a flat tax in the American presidential primaries in 1998, it was widely dismissed as no more than an eccentric millionaire's fantasy.

An idea that failed to gain purchase in the United States is, however, fast winning converts right across central Europe. At the 2003 capitalist ball Mart Laar, a former prime minister of Estonia, was given a special award to celebrate the fact that, in 1994, his country had become the first in Europe to introduce a flat tax, of 26%. At the time, developments in Estonia, a tiny Baltic country which was not then even a member of the EU, did not seem particularly significant. True, Latvia and Lithuania, the two other Baltic countries, swiftly followed suit, but nothing much happened for a while after that.

Then in 2001 Russia, facing widespread tax evasion, moved to a flat tax of 13% on personal income. Over the next two years

Serbia and Ukraine followed, with rates of 14% and 13%, respectively. Much as advocates of the privatisation of pensions were sometimes embarrassed to have Pinochet's Chile as their laboratory, so Russia, Serbia and pre-Yushchenko Ukraine were not the ideal poster children for flat taxes. But then Georgia, fresh from a democratic revolution, introduced the lowest flat tax yet: 12%. And the flat-tax experiment that has attracted most attention in the EU has been in Slovakia, where a 19% rate for all personal, corporate and sales taxes was introduced in 2003.

Slovakia's flat tax became a lot more significant when the country joined the EU a year later, thereby gaining complete and unfettered access to Europe's single market. As advocates of the flat tax had long predicted, Slovakia's fiscal innovation helped to spur foreign investment and economic growth, while actually leading to a slight increase in tax revenues. Encouraged by Slovakia's experience, Romania, which is supposed to join the EU in 2007, has just introduced a flat tax of 16%. The centre-right opposition parties in Poland and the Czech Republic are both now pushing the idea of flat taxes set at 15%.

To many in the rich, high-tax countries of western Europe, all of this smacks of the dreaded "race to the bottom", long forecast by those who feared that the enlargement of the EU would lead to a loss of jobs and an erosion of the welfare state. Joschka Fischer, the German foreign minister, has argued that it is intolerable for his country, struggling with a rising budget deficit and unemployment of over 10%, to finance EU subsidies to countries that are luring investment and jobs out of Germany by slashing taxes. As Mr Fischer sees it, the Slovaks and others can afford to set low flat taxes only thanks to big EU subsidies. Reality is more complex. That tax revenues have actually risen in Slovakia makes it a lot harder to sustain the charge of "fiscal dumping". The main cost advantage that central Europe has over Germany and France is not low taxes, but low wages: an average Slovak worker is paid about a fifth as much as his German counterpart.

### If you can't beat 'em

Flat-taxers are in such an exuberant mood that they risk feeding the myth of fiscal dumping. At a recent Brussels seminar organised by the Stockholm Network of pro-market think-tanks, Dan Mitchell of America's Heritage Foundation crowed that France and Germany are "being caught in a pincer movement" by their flat-tax neighbours. "The money is going to leave those countries, investment will be leaving those countries, and sooner or later they will have to reform." Mr Mitchell predicts that the flat-tax movement in Europe will be imitated around the world, rather like the Thatcher-Reagan cuts in income-tax rates and Ireland's cuts in corporate tax.

So far, the preferred response of the Germans and French is to press for an EU-wide ban on "fiscal dumping" and to push the EU towards tax harmonisation. The trouble is that EU decisions on tax are taken by unanimity—and there is no way that the Slovaks and others are going to surrender their freedom to set their own taxes. So some in western Europe are beginning to think of copying the flat-taxers, rather than fulminating against them. Gerrit Zalm, the Dutch finance minister, has said that his Liberal Party is considering a flat tax for the Netherlands, albeit at the high rate of over 30%. More surprisingly, advisers to left-of-centre governments in Spain and Germany have also done serious feasibility studies on flat taxes. If old Europe cannot beat the flat-taxers of new Europe, it may have to join them. ■